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No. 839

In the Supreme Court of the United States

OCTOBER TERM, 1959

THE SMOOT SAND & GRAVEL CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The first memorandum findings of fact and opinion of the Tax Court (I R. 18a-55a) are not officially reported. The first opinion of the Court of Appeals (Pet. 1a-19a) is reported at 241 F. 2d 197, certiorari denied, 354 U. S. 922, rehearing denied, 354 U.S. 943. The second memorandum findings of fact and opinion of the Tax Court (I R. 57a-73a) are not officially reported. The second opinion of the Court of Appeals (Pet. 21a-39a) is reported at 274 F. 2d 495.

JURISDICTION

The judgment of the Court of Appeals was entered on January 11, 1960. (Pet. 40a.) Taxpayer's petition for rehearing was denied on February 24, 1960. (Pet. 41a.) The petition for a writ of certiorari was filed on April 7, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the courts below erred in finding that, under Section 102 of the Internal Revenue Code of 1939, the corporate taxpayer accumulated earnings and profits during the years 1945-1950 for the purpose of preventing the imposition of surtax upon its shareholders and the shareholders of another corporation.

2. Whether the courts below erred in finding that the taxpayer had not shown that the reasonable needs of its business in the taxable years involved required more than amounts shown on its books as reserves.

3. Whether the Court of Appeals erred in finding that there was affirmative proof of an intention by the taxpayer to retain its net earnings for the purpose of avoiding the surtax upon its stockholders.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved are Section 102 (a) and (c) of the Internal Revenue Code of 1939, and Section 534 of the Internal Revenue Code of 1954. These, and the relevant provisions of Sections 29.102-1, 29.102-2, and 29.102-3 of Treasury Regulations 111, are set out in the Appendix, *infra*, pp. 14-20.

STATEMENT

The facts, as stipulated and as found by the Tax Court (I R. 19a-41a), may be summarized as follows:

Taxpayer was organized in 1927. It owns and operates a sand and gravel business founded by L. E. Smoot in 1899. All of its capital stock is owned by Columbia Sand & Gravel Company, Inc. L. E. Smoot is the owner of all the common stock of the latter. He is also president of taxpayer and chairman of its board of directors. (I R. 19a-20a.)

Taxpayer has had net earnings in every year since 1927 in amounts ranging from $190,548.86 to $1,052,939.32. (I R. 38a, 43a.) It paid dividends of $20,000 in 1928 and $800,000 in 1932. It has paid no further dividends. (I R. 41a.) At the beginning of 1945, taxpayer had accumulated earnings and reserves of $6,197,061.88. At the end of 1945, it had cash of approximately $3,000,000 and Government obligations amounting to more than $1,300,000. Its balance sheets showed a surplus of $2,088,596.99 above its liabilities, which included the amount of $4,298,728.25 for reserves. (I R. 38a-39a.) The surplus increased to $2,908,702.60 at the end of 1950. (I R. 40a.)

The Commissioner determined that taxpayer was availed of during each of the years 1945 to 1950, inclusive, for the purpose of preventing the imposition of surtax upon its sole stockholder, Columbia Sand & Gravel Company, Inc., and on L. E. Smoot, through the medium of permitting its earnings and

profits to accumulate instead of being divided or distributed, thereby incurring liability for the surtax imposed by Section 102 of the Internal Revenue Code of 1939. (I R. 41a-42a.)

Taxpayer challenged this determination on the ground that its accumulated earnings were less than the amounts reasonably needed in its business, and that the amounts shown as reserves on its books did not reflect its actual needs. (I R. 42a.) The Tax Court held that taxpayer had not demonstrated that its needs were greater than those shown by the reserves on its books. (I R. 53a.) It considered the various items covered by these reserves—taxpayer's liability as a self-insurer (I R. 44a-46a); loans to customers (I R. 46a); needs for new plant and equipment, for postwar rehabilitation, and for sand and gravel replacement (I R. 46a-48a); a reserve for bonded indebtedness (I R. 49a-51a)—and held that taxpayer had not shown the existence of a plan for future expansion which would justify the retention of greater reserves. (I R. 46a-48a.)

Upon review, the Court of Appeals agreed with the Tax Court, with three exceptions. (Pet. 5a-19a.) One exception concerned a $250,000 reserve set up by taxpayer in lieu of obtaining performance bonds on its job contracts. The Court of Appeals pointed out that a bonded contractor still remains liable to his surety for performance of the contract, and that accordingly the fact that taxpayer did not use performance bonds did not increase the liability it would have had if bonded. It found no justification for this reserve. (Pet. 10a.) On two other items, the need

and amount of resources for entering the ready-mix concrete business (Pet. 11a-16a) and a determination of the amount of working capital needed (Pet. 16a-18a), the Court of Appeals remanded the case to the Tax Court for further findings (Pet. 19a).

On remand, following the denial of certiorari, the Tax Court found that taxpayer did not at any time during the years involved formulate any definite plan, make any commitments, or take any course of action preparatory to entering into the ready-mix concrete business; and that it has never at any time intended to enter into the ready-mix concrete business, at least unless forced to do so in order to protect its sand and gravel business. It further found that the taxpayer's business of producing and selling sand and gravel was not at any time under any threat which might reasonably have been regarded by its officers as likely to force the taxpayer to enter into the ready-mix business; and that, if any such threat ever existed, it did not extend beyond 1940 at the latest. Finally, it found that during the taxable period involved, the taxpayer's officers had no reasonable cause to consider entry into the ready-mix business as more than a remote possibility, or to accumulate the taxpayer's earnings and profits for that purpose (I R. 58a.)[1] The Court of Appeals accepted

[1] In its petition for certiorari (pp. 8-10), the taxpayer ignores these findings and quotes as the findings of the Tax Court its findings in its first opinion. In its second opinion, the Tax Court explains its first opinion and then expressly states (I R. 60a) that—

> If this is inconsistent with our previous findings, then, on the whole record as supplemented at the fur-

these findings. (Pet. 23a-28a.)[2]

On the remand, the Tax Court further found that the taxpayer's working capital needs for each year ran between $191,693.94 and $351,667.37. (I R. 67a.) In determining the taxpayer's total needs for such reserves, it allowed $500,000 for each year. (I R. 66a-68a.) The Court of Appeals accepted this figure as being more than enough. (Pet. 28a-29a, 35a.).

In determining the ultimate factual question whether the taxpayer was accumulating its earnings or profits beyond the reasonable needs of its business, the Tax Court accepted, for each year, the figure for surplus, consisting of surplus not earmarked and reserves shown on the books, taken from the stipulated balance sheets of the company (Pet. 38a-39a), and subtracted therefrom the "Reserves accepted as reasonable," plus "Loans to customers," and $500,000 for working capital. The difference, amounting to $1,515,679.99, on December 31, 1945, and rising steadily to $2,316,197.60 on December 31, 1950, it found to be the minimum unreasonable accumulation.

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ther hearing, we must regard those findings as erroneous, at least by implication, and accordingly revised as stated above.

[2] In its petition for certiorari (p. 11), the taxpayer states that the Court of Appeals "recognized that petitioner's 'officers sincerely believed that it would be forced into the ready-mixed concrete industry' during 1945-1950," and that "The Court of Appeals seemingly does not doubt that" this belief existed. The court's opinion, however, sets this out as the taxpayer's "main contention" (Pet. 25a), and proceeds to reject it (Pet. 25a-28a).

(I R. 67a-69a.) The Court of Appeals noted that the Tax Court was "overgenerous" in allowing $500,000 for the purchase of concrete mixing equipment, $500,000 for working capital, and $250,000 for contract bonds. (Pet. 35a.) It noted its own doubts as to the justification for the allowance of the large reserve of $1,333,000 for "post war rehabilitation." (Pet. 36a.) It agreed with the Tax Court's ultimate conclusion, stating it was "clearly correct." (Pet. 37a.)

In its second appeal to the Court of Appeals, the taxpayer argued that, in addition to the reserves of $1,333,000 for postwar rehabilitation and $100,000 for sand and gravel replacement, as set out on its books (Pet, 39a), it should also be entitled to deduct amounts covering depreciation, depletion, and bad debts. The court rejected this contention, pointing out that charges for bad debts, depreciation, and depletion had already been taken into account in determining the taxpayer's total assets and its surplus. (Pet. 32a-33a.) As to taxpayer's contention that it was entitled to a greater allowance for income tax liability, the court pointed out that there was an allowance for such liability, and that even if the taxpayer should be allowed a greater reserve it would not change the result in this case. (Pet. 33a-35a.)

This case arose under Section 102 of the Internal Revenue Code of 1939. Section 534 of the Internal Revenue Code of 1954 provides that in certain cases the burden of proof should be on the Commissioner. The Act of August 11, 1955, amended Section 534 to make it retroactive, but with a limitation that it

should apply only in the case of proceedings tried on the merits after August 11, 1955. This case was originally heard in June, 1954. (I R. 69a.) The Tax Court, in its second opinion, held this provision to be inapplicable to the present case. (I R. 69a-72a.) Assuming, however, that the burden of proof was on the Government, the Tax Court found that this burden was met by affirmative proof of "a deliberate, consistent and inescapable intention * * * to retain * * * net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders." (I R. 72a-73a.) The Court of Appeals agreed. (Pet. 37a.)

ARGUMENT

1. The purpose of Section 102 of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 14) is to compel a company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable for tax on the dividends received. *Helvering* v. *Stock Yards Co.*, 318 U. S. 693, 699. Its application depends upon the purpose for which the corporation was organized, or for which it was used during the taxable year. The inquiry whether the corporation is being used for the purpose of avoiding surtax on shareholders and whether accumulated profits are beyond the reasonable needs of the business is one of fact. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Helvering* v. *Stock Yards Co.*, 318 U.S. 693.

In this case, the Court of Appeals sustained the findings of the Tax Court, both as to the subsidiary facts and as to the ultimate factual question. Taxpayer is here seeking a second appellate review of factual issues which were fully argued and extensively considered in both courts below, and on which those courts are in agreement.

The petition for certiorari erroneously suggests that the Tax Court found the basic facts in accordance with the taxpayer's contentions, and that accordingly there is a conflict between the courts below. For example, the petition (p. 6) sets up a schedule purporting to show that the taxpayer had a deficit for each of the years 1945 through 1950, based upon its liabilities and reserves "found below." The fact is that the Tax Court found that the taxpayer had net earnings for each of those years (I R. 38a), and had surpluses, increasing during those years (I R. 68a). Indeed, one of the taxpayer's complaints in the Court of Appeals on the second review was that the Tax Court had *not* agreed that there were the deficits claimed. (I R. 19-28.)

The petition also states (p. 6) that the Tax Court "found" the cost to cover depreciation and replacement "was from $4,366,489.38 to $6,700,733.16," citing I R. 33a-34a. The Tax Court found nothing of the sort. It recited that the taxpayer, for purposes of this proceeding, had had an appraisal made in 1953 which contained these figures (I R. 33a-34a)—figures which the Tax Court did not accept (I R. 46a-47a).

Again, the petition states (p. 7) that the Court of Appeals held that the taxpayer was not entitled to accumulate "any earnings whatsoever" to replace its assets. This is not what the Court of Appeals held. It agreed that there could be accumulation for such replacement (Pet. 33a), and, with some doubts, allowed the sum of $1,333,000 (Pet. 36a).

The original findings of the Tax Court as to the ready-mix concrete business, set out in full in the petition (pp. 8-10), were expressly repudiated by the Tax Court and supplanted by its findings in its second opinion. The statements (Pet. 10) as to alleged threats to Mr. Smoot and pressure to use the anti-trust laws against him were rejected by the Court of Appeals (Pet. 25a). Again, as noted above, the petition errs in stating (p. 11) that the Court of Appeals "recognized" that taxpayer's officers sincerely believed that it would be forced into the ready-mixed concrete industry; the court was merely reciting the taxpayer's contention, which it rejected (Pet. 25a).

2. Taxpayer argues that the court below erred in not allowing any reserve for the replacement of exhausted assets. (Pet. 12-18.) This contention, however, ignores the fact that the court did recognize the need and did allow a reserve. Its opinion states (Pet. 33a):

> We are cognizant of the fact that replacement of taxpayer's wasting assets will ultimately become necessary, and that for this purpose cash or other liquid assets must be available; but, as will appear, taxpayer had much more liquidity than necessary for such replacement and for all other reasonable business needs.

Later, the opinion states (Pet. 36a):

> Thus, petitioner had liquid assets of more than $5,500,000, much in excess of what was reasonably required in the business (even after taking into consideration amounts necessary to replace depreciated and depleted property).

Furthermore, the reserves set up on the taxpayer's books, accepted by both courts (I R. 48a, 68a; Pet. 36a), contained an amount of $1,333,000 for future replacement of depreciated and depleted assets, and $100,000 for sand and gravel replacement (Pet. 39a). The Court of Appeals recognized the need for such a reserve and held that allowance of the $1,333,000 which taxpayer had itself set up on its books was more than reasonable. (Pet. 36a.)

The Court of Appeals, therefore, did precisely what the taxpayer is here contending it ought to have done—allow a reserve to replace exhausted assets. Taxpayer is merely asking this Court to reconsider the amount that should be allowed.[3]

2. The taxpayer's contention (Pet. 18-21) that the court should determine the question of unreasonable accumulation from the point of view of the years involved, and not from hindsight, ignores the fact that this was the test applied. The courts below determined the reasonable needs of the business as they appeared during the taxable years. (Pet. 7a-8a.) They agreed that "the controlling intention of the

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[3] In fact, the taxpayer did replace much of its equipment and acquire dredging rights during the years involved, out of current earnings or general surplus. (I R. 26a-27a, 36a, 47a.)

taxpayer is that which is manifested at the time of the accumulation * * *." (Pet. 7a.) In considering the ready-mix concrete question, both courts below examined the evidence and the facts as they appeared at the time in question. (I R. 59a-64a; Pet. 23a-28a.) The taxpayer is merely disagreeing with the weight given by those courts to the evidence.

3. Taxpayer's next contention (Pet. 21-24) is an invitation to this Court to redetermine the factual questions involved in the entire case. As pointed out above, the claimed deficits were not found to exist by the Tax Court, nor are they supported by the stipulated facts. The asserted deficits rest in part on a mathematical error, as pointed out by the Court of Appeals. (Pet. 32a-33a.) The amounts were obtained by subtracting from net assets all of the special or contingent reserves (I R. 34a) shown on the balance sheets (Pet. 39a), plus the accounting reserves for notes and accounts receivable, depreciable assets, and dredging rights (Pet. 39a; I R. 20-21). But, as pointed out by the Court of Appeals (Pet. 32a-33a), this last group of accounting reserves had already been deducted from the values for notes and accounts receivable, for depreciable assets, and for dredging rights (Pet. 38a).

4. The Court of Appeals held (Pet. 37a) that—

> even assuming that the burden of proof was on the Government, we are convinced, as was the Tax Court, that this burden has been met by affirmative proof of "a deliberate, consistent and inescapable intention to retain its net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders.

The petition misstates this as an "assumption" as to what the result might have been had there been a new trial. (Pet. 27-28.) As the opinion of the Court of Appeals shows on its face, no such assumption was made. The Court of Appeals, declining to decide whether the burden of proof had been shifted to the Commissioner, agreed with what the Tax Court had held (I R. 72a-73a), *i.e.*, that the burden, if there was one, was met. For a similar disposition of this problem, see *I. A. Dress Co.* v. *Commissioner*, 273 F. 2d 543, 544 (C. A. 2d), petition for certiorari pending, No. 832, October Term, 1959.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MAY, 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) [as amended by Sec. 103(d) of the Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * *

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

* * * *

(26 U.S.C. 1952 ed., Sec. 102.)

Internal Revenue Code of 1954:

SEC. 534. BURDEN OF PROOF.

(a) *General Rule.*—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) [as amended by Sec. 5 of the Act of August 11, 1955, c. 805, 69 Stat. 689] *Notification by Secretary.*—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statement by Taxpayer.*—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) *Jeopardy Assessment.*—If pursuant to section 6861(a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) [as amended by Sec. 4 of the Act of August 11, 1955, *supra*] *Application of Section.*—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits

after the date of the enactment of this paragraph.

(26 U.S.C. 534.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.102-1. *Taxation of Corporation Formed or Utilized for Avoidance of Surtax.*— Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 501, and foreign personal holding companies, as defined in Supplement P (see section 331), are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

* * * *

SEC. 29.102-2. *Purpose to Avoid Surtax; Evidence; Burden of Proof; Definition of Holding or Investment Company.*—The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the Internal Revenue Code, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earn-

ings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders.

If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *deter-*

minative of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

* * * *

SEC. 29.102-3. *Unreasonable Accumulation of Profits.*—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

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